The Fall of Our Discontent

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Commentary

The title for this article is a variation of a line from Shakespeare, which is appropriate for our crystal ball outlook as we search for insights into what lies ahead. The original "winter of our discontent" was something of a misnomer; it was a forward-looking statement with better times on the horizon, rather than a commentary on the current situation. While we are ultimately in the same situation, the horizon is a long way off, and there is no doubt that we will encounter a number of twists and turns. Unfortunately, rather than being able to take comfort and relax by the fire as we read a classic tome that helps us relive history, we will be on the front lines, creating the history about which others will someday read. It's time to hunker down for what may be a long journey down the road less taken.

During the first half of the year, it looked like the economic recovery in the United States was moving onto firm ground. This led to rising confidence that the commercial real estate market had finally weathered the storm. However, several recent events suggest the storm is far from over and that the worst may be yet to come. For many, the belief that the economy is on firm ground has been shattered. We are in unchartered and unexpected territory, with an economy that is on shaky ground at best, and many people are already operating as though another recession has swept the country.

The feeling of discontent that has spread across the country can be traced to two major triggers. The first trigger was the rancor and brinksmanship among political parties that took the government to the brink of default. While the temporary agreement bought some time in Washington, few on Main Street believe that a sense of conciliation is likely to supplant the combativeness modus operandi of lawmakers. Rather, the average American continues to feel disenfranchised, with a sense that no one in power has their interests at heart. Many believe that no one is in charge, which has translated to record-low ratings for both parties and politicians in general. Nothing that has come out of Washington recently has done anything to regain the confidence of the American public, with finger-pointing and talks of class warfare creating even more angst.

In addition to political posturing, the two parties remain at odds regarding how to address the sticky unemployment situation, with Republicans favoring permanent tax cuts and deregulation, and Democrats seeking more federal spending to stimulate activity and short-term tax reductions to provide a more immediate effect. Some have hopes that the congressional super committee will be able to come up with a compromise on the budget cutting and revenue sides of the equation. However, attention may well shift to the special interest groups and lobbyists behind the scenes that will exert extreme pressure on the committee and members of Congress.

The second trigger of discontent started in New York and has now spread across the country. While initially characterized as a leaderless group with no set agenda, the Occupy Together grassroots movement has gained significant traction. In addition to the populist appeal of the protest, it has exploded through use of the Internet and social media, including a number of websites (i.e., www.occupywallst.org), Facebook, Twitter, and live Internet feeds, similar to the Arab Spring. The unofficial Occupy Together hub reports over 8,500 occupiers in 1,389 cities nationwide. In addition to focusing on solidarity regarding the discontent of their followers and helping spread the message by nurturing and guiding organizations across the country, the leaders of this self-proclaimed leaderless group have been exploring the organization of a national event. Local

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jurisdictions have been tolerant within some cities (i.e., New York, Washington DC, Chicago), and some have extended deadlines for protests in an effort to avoid an escalation of protests. An interesting twist that demonstrated the intuitive appeal of the movement was revealed by Federal Reserve (Fed) Chair Ben Bernanke in his October 4 appearance before Congress's Joint Economic Committee. In response to a question regarding the protestors, he noted that there might have been some justification since the financial sector helped get us in the current mess. While some discount the movement, it has the potential to create a rallying point that voters can use to make a potent statement to Wall Street and politicians. The way things are going in Washington, an Occupy Congress movement may be on the horizon.

The Changing Economic Environment: A Prelude

At the beginning of summer 2011, the economic environment started to sputter, and the foundation for a sustainable recovery began to crumble. Consequently, talk of a double-dip recession began to gain traction. While most prognosticators had forecast rather modest growth relative to typical recovery periods, the actual numbers were even more bearish and caught many off guard as they were forced to ratchet in their expectations.

An increasing number of Americans are worried that the US economy may slip back into recession. In a recent Wall Street Journal/NBC poll, nearly 74% of respondents indicated they thought the economy is on the wrong track, which is approaching the pessimistic levels held during the financial crisis in 2008. Respondents also did not anticipate much improvement, with 32% expecting the economy to get worse over the next twelve months, 45% expecting it to stay the same, and only 21% expecting it to get better. Even those anticipating improvement were guarded, with few expecting robust growth in the near future. These types of perceptions are not isolated to consumers. The survey's sentiments were fairly widespread, being shared by small business owners, consumers, and workers who will all play a key role in determining the ultimate fate of the economy.

The widespread frustration with the current economic path and the economic outlook has not been lost on the Fed and policy makers; but, the former have few options left to stimulate growth, and the latter can't seem to get their act together. For example, the Fed's recent Operation Twist evoked more than a little reaction from the public and Wall Street. It triggered a 2.5% drop the next day, which set the stage for the worst week of performance in about three years. The discontent that hit investors came from recognition that shifting from short- to long-term holdings, and changing the duration of its portfolio, would likely have a marginal impact on the overall economy with little trickle down to stimulate growth. However, the program appears to have achieved some of its goals, as long-term rates have fallen and investors have started looking at riskier assets in pursuit of higher returns. This incentivized shift may work to a certain extent; but, it could also backfire if the higher-risk investments stumble and investors' portfolios take another hit.

It is clear that Operation Twist and other forms of government intervention will be played out on the public stage in the global arena through social networking. From this point forward, issues and actions of the public and private sectors will experience unprecedented visibility and transparency, which may bring unanticipated and unpredictable reactions, volatility, and unrest. This situation is punctuated by the fact that a recent Google search for the keywords Twitter and Operation Twist provided over 600,000 hits; dropping Twitter from the search yielded a tenfold increase in hits. While some naysayers have characterized such flashes of wit and wisdom as an artifact of the time, an entirely new industry has sprung up to mine the data and extract meaningful signals from all the presumably independent and meaningless chatter exploding across the Internet. For example, in a query of Twitter Sentiment, 75% of the posts were negative while 25% were positive, albeit on a relatively limited count. Similar results can be expected regarding a range of economic, political, and social issues.

The explosion in social networking, coupled with unprecedented Internet access on smart phones, tablets, and other technological innovations, has become a real game-changer. While some characterize social networking as a temporary diversion that has little meaning outside of its entertainment value, the trend may forever change the stimulus-response linkage on the political, economic, and personal levels. At a minimum, on the political frontier it will create greater transparency and spawn a rapidly expanding forum for debate. In the hands of increasingly techno-savvy advocates and interest groups, it is likely to be easier than ever to grab public attention on issues that have been largely overlooked. Clearly, retailers, moviemakers, news organizations, and trade associations have already realized the potential of social networking. As the new and innovative opportunities created by technological innovations are exploited, political debates that have been argued behind closed doors may become passé. This could create an intellectual disintermediation that allows the public to pierce through traditional rhetoric and come to its own conclusions about what could, and should, be done.

While the previous scenario might seem far-fetched, one only needs to take a look at the Occupy Wall Street movement and explore the Internet to see how far things have come so fast. Washington continues to struggle with what to do to keep up with the technological advances in communication over the short term, while some individuals focus on advancing their own agenda. Those who choose to ignore these advances could find themselves technologically crippled, and ultimately be left behind. As is evident, technology is not likely to roll back. Even though economic times will continue to be tough, voters and Main Streeters may find some entertainment and educational value as they watch future events unfold.

Economic Growth

During the 2011 third quarter, the threat of a double-dip recession in the United States dramatically increased. Many prognosticators still report a significant risk for another downturn. However, there were some signs that the situation might improve if Europe's crisis stabilized and Washington was able to get its act together. Washington needs to deal with the underlying problems, rather than dancing around the issues. Ominously, at the end of the first week in October 2011, the Economic Cycle Research Institute (ECRI) reported that the country has already, or will shortly, slip into a recession. While met with some skepticism by a number of economists, it was no surprise to many on Main Street. A significant portion of the findings were based on the stock market, which has been extremely volatile and may reflect investor angst rather than economic realities. However, ECRI pointed to their finding that the three P's of a recession had been met: the decline has been *pronounced*, *pervasive*, and *persistent*.

Regardless of official designations, many small businesses and households wonder whether the term double-dip even applies, as many feel they have never recovered from last recession. For the first three quarters of 2011, gross domestic product (GDP) growth was disappointing at best, coming in under 2% annualized. Despite some upward revisions related to improvement in consumer spending and exports, the near-term outlook for GDP remains guarded with more downside risk than upside potential. The fourth quarter figures will be a key to the recession debate; but, political uncertainty and widespread discontent perhaps will be more important than the actual data on the economy.

One of the more dramatic trends that complicated accurate forecasts for the US economy has been the significant increase in the integration of global economies. This trend is likely to increase dramatically as countries find their economies intertwined with others. To a certain extent, the locus of control has shifted offshore, which has limited the impact US policy makers can have on controlling our own destiny. The country has become more dependent on offshore capital flows, which can no longer be taken for granted. This is one reason why the credit downgrade, related in part to budget realities and world-wide awareness of the dysfunctional situation in Washington, has placed at risk the economic recovery and the role of the United States as a safe-haven.

The global connectivity and its impact on the US economy have been punctuated by the ongoing crisis in Western Europe that, at times, looked like it might threaten the euro-zone agreement. The debates and deadlocks in arriving at a solution have been even more rancorous and divisive than the debates in Washington. This situation is understandable, given the number of competing interest groups and constituencies that must be considered in arriving at an agreement.

In the fall 2008 column, we talked about the crisis in confidence that was dominating the economic outlook. Confidence, once again, has become one of the leading indicators that will determine the fate of the economy. Thus, it is useful to provide a brief synopsis of the various measures of confidence that should be tracked as we move through the "fall of our discontent."

Employment

After showing some signs of potential improvement in mid-2011, the employment situation has continued to struggle as employers pull back once again in response to uncertainty in the market. The figures released in early October were fairly positive and showed slightly over 100,000 jobs created, which was welcome news after several disappointing reports. The biggest improvements were in private sector service, professional services, health care, and construction. On the other hand, losses occurred in government—primarily local—and manufacturing, which occurred on the heels of moderate declines in August. On a cautionary note, it should be mentioned that the figures included some 20,000 new part-time jobs, which could quickly erode if economic conditions deteriorate.

The Conference Board Help Wanted OnLine (HWOL) data series provides some insight into the job situation. In September 2011, online job advertisements continued a downward trend that has held for six months, during which nearly 500,000 advertised jobs were lost. This ate into the gains reported at the beginning of the year and punctuates the deterioration in employment opportunity that is all too familiar to the unemployed. Currently, there are about 3.5 unemployed workers for each job advertised. At an aggregate level in the United States, the ranks of the unemployed outpace the number of advertised jobs by almost 10 million. As might be expected, these ratios vary widely and range from 0.94 in North Dakota to 7.89 in Mississippi. In general, demand for sales, management, computer science, and mathematics dropped in the recent figures, while health care, technical, office, and administrative support increased. In many sectors, there is a significant mismatch between jobs and the skill sets of the unemployed. This is unlikely to change without some form of intervention or renewed emphasis on job training. Finally, those who do find jobs are often forced to accept lower salaries and benefits. This has made it more difficult for them to recover from what, in many cases, was a prolonged period of unemployment. Against such odds, it is not that surprising that workers continue to drop out of the labor force. This leads to an understatement of the plight of many, especially those at the lower end of the socioeconomic and educational system.

The continued plight of the unemployed is a hot spot of the anti-Wall Street movement and punctuates the gaps between the haves and have-nots. This disconnect is noted by the significant differences in the fate of the college educated, for whom unemployment rates are relatively strong. At the other end of the educational spectrum, however, the situation is markedly different. Laid-off workers either sit on the sidelines in search of a job or are underemployed in terms of occupation, income, and benefits.

Looking forward, the Employment Trends Index (ETI), published by The Conference Board, slipped slightly in September, although the ETI remains relatively flat around 100. This is an improvement over the past two years; but, it is significantly below the low 120s reported before the recession set in. The monthly index has been an accurate leading indicator of total non-farm employment, and it bears close monitoring. It combines some key metrics, including percent reporting that jobs are hard to get, initial claims for unemployment, percent of firms with positions they are not able to fill now, number of temporary employees hired, part-time workers for economic reasons, job openings, industrial production, and real manufacturing and trade sales. Thus, while the recent downturn does not constitute a trend, it suggests that job growth is likely to plateau until conditions begin to improve. Unfortunately, there are few signs that the myriad factors will improve, and it is unclear which factors might improve.

While the current employment situation remains bleak, efforts continue to develop jobs stimulus programs. For example, the President's Council on Jobs and Competitiveness, formed at the beginning of 2011, has developed a number of initiatives to help break the political logjam in Washington. These initiatives include accelerating investment in infrastructure and energy projects, creating programs to support entrepreneurship and fast-growing firms, developing incentives to attract more foreign investment, simplifying regulatory reviews, streamlining project approvals, and creating training and skill-development programs in concert with private sector. The council placed emphasis on programs that do not rely solely on government funding, including expedited approvals for Small Business Administration loans and tax breaks for business investments under $25 million that are held for five years or more. Regarding infrastructure, the council recommended the creation of a bank to blend federal, local, and private-sector sources of capital.

The programs suggested by the council are likely to be subjected to considerable debate, and a number are likely to face the same fate as President Obama's $447 billion American Jobs Act (AJA) job creation program that was defeated on October 11, 2011 in the Senate. As expected, President Obama quickly adopted a fallback position, breaking the legislation into smaller packages that might help overcome the gridlock. One proposed program would provide tax breaks for business owners that hire recent veterans, over a million of whom are out of work. Other programs are expected to be introduced by Republican leaders, some of which are likely to gain bipartisan support. Assuming politicians can set aside their differences, in part due to public scrutiny and pressure to move forward, there may be hope for meaningful jobs creation programs, especially those that leverage public and private-sector capital or spill over to the private sector.

Business Indicators

In the current environment of discontent, it is useful to take a two-stage look at business indicators that begin with actual figures and trends and end with an analysis of business confidence levels. During August 2011, The Conference Board Leading Economic Index (LEI) continued to trend up as it had for the prior several months while the Coincident Economic Index (CEI) remained flat. The improvement was led by factors that track current financial and monetary conditions, while those related to future expectations declined. The modest growth trend was fairly balanced, with the number of positive factors close to the number of negatives. Overall, the figures suggest more risk exposures and a continuation of the recent volatility that may put downside risk on the recovery.

In terms of individual indicators, the recent results are fairly mixed. For example, manufacturing reported an unexpected increase in September that benefited from increases in export demand and production levels. Some of this improvement might be temporary, and it is dependent on the global economy's ability to stabilize the debt crisis hanging over Europe and other markets around the world. The new-orders index remained sluggish and below the neutral level. This suggests there may be downward pressure on manufacturing, especially as the Japanese automobile industry recovers. The non-manufacturing index has also experienced some improvement, stabilizing after the decline that began earlier in 2011. Oil inventories have continued to decline, reversing much of the increases that occurred in the first half of the year with domestic production getting back on track after the storm-related shutdowns and imports falling. On the other hand, wholesale inventories have continued to increase; although the recent pace has fallen below the rebound reported earlier in the year. Business inventories have been relatively stable to flat, reflecting the growing uncertainty surrounding the economic conditions and business expectations. Productivity levels were disappointing and declined in the first half of the year, reversing a trend that had held since the recession formally ended.

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Given the importance that small businesses play in job creation, small business confidence levels are also noteworthy. According to the National Federation of Independent Business (NFIB), despite a miniscule gain in September, small business confidence levels remain at rather depressed levels. On a seasonally adjusted basis, the Small Business Optimism Index was dragged down by a decline in earnings, expectations for the economy, expected credit conditions, and expected trends in real sales. Symptomatic of the challenging times small business owners face, the good news is that the net percent of owners expecting sales to decline became less negative. Small business owners also reported some improvement in plans to make capital outlays and in current job openings; although, those indicators are subject to significant downside risk given the tentative nature of the recovery. Access to credit is not the real problem as much as the lack of interest in taking on credit in light of prospects for flat demand for products and services. The situation is likely to carry well into next year, based partly on a reported decline in the net percent of owners expecting better business conditions over the next six months.

Large businesses continue to fare better than their smaller counterparts; although, CEOs remain on the defensive. During the 2011 third quarter, The Conference Board Measure of CEO Confidence continued the downward trend reported in the second quarter. This trend dragged confidence levels down to 42, compared to the 55 in the previous quarter. A reading of 50 indicates a balance between those reporting positive and negative responses, with the current level the lowest it has been in over two years. The index has gone down due to a number of factors, including the tepid rate of economic growth and the gridlock that stands in the way of near-term improvement. As a result, large companies are scaling back on capital spending plans, and some are actually making cuts. In this environment, capital expenditures and employment trends will depend on sales and revenue growth. The situation is unlikely to improve over the near term, with less than 20% of CEOs expecting near-term improvement in economic conditions.

Given the increasingly global nature of the economy and capital markets, looking at business confidence at the global level also provides revealing insights. Moody's Analytics tracks business confidence on a weekly basis. Going into 2011, business confidence levels were fairly respectable—especially in light of the uncertainty that surrounded the global economy. After a slight decline in the first half of the year, these confidence levels plummeted, suggesting that the global economy also will have to overcome some significant headwinds before returning to a growth mode.

Stock Market

A troubling issue that has hung over the stock market is the widespread concern over the European debt crisis. After prolonged consternation associated with the European financial crisis, the leaders of France and Germany—the two largest euro-zone countries—announced on Columbus Day that they were close to a deal that could help recapitalize troubled European banks and resolve the sovereign debt crisis. That led to a quick stock market rally in the United States and Europe, as well as other world stock markets as investors responded to the good news.

Despite this uptick, stock markets are likely to exhibit significant volatility until the debt crisis is actually resolved and global economic activity begins to pick up. After a tumultuous period in early August, the US stock market has shown some improvement; although, volatility and uncertainty are likely to remain for some time. This outlook is not isolated to the United States; it extends to global stock markets as well, with few signs of any safe havens that are immune to such gyrations. That said, investors are likely to continue to seek returns and may be willing to take on more risk as they seek to regain some of the lost ground they have experienced in their overall portfolios. However, many smaller investors are likely to stay on the sidelines and listen to the new theme offered by Simon Constable in an October 2 *Wall Street Journal* article about investors who "Won't Get Fooled Again." Thus, the bears are likely to outnumber the bulls and lead to interesting times of give and take. Unfortunately, bear sessions will be easier to spot than bull ones until some stability and a renewed sense of certainty returns to the market.

Inflation and Interest Rates

Over the past several quarters, food and energy price increases have eaten into disposable income, creating some concern that increases may spill over to other goods. Fortunately, core prices have not shown any significant increases, creeping slightly upward in August, but still at the lowest rate of increase since the beginning of the second quarter. While the weak dollar has placed some upward pressure on import prices, softened global demand and deteriorating consumer confidence levels dampened upward pressure on prices. Similarly, the recent improvement in retail sales was not sustainable, especially in light of the declines in personal income and disposable income reported in August. Some households have dug into their savings rather than taking on revolving debt, a trend that is unlikely to occur in the face of growing uncertainty and discontent. This will take demand-side inflation out of the equation and give the Fed some room to explore new stimulus measures; although there are few options left.

Conditions regarding credit have improved somewhat; but, many borrowers have been reluctant to take on additional debt in the face of growing uncertainty. Financial institutions have had a challenging time on the valuation front as scrutiny over balance sheets, corporate practices, and risk management have received more attention. An example of this scrutiny was the public outrage over the Bank America's proposal to charge debit card fees as it pursues its inherent right to make a larger profit and stretch margins to levels it feels are appropriate.

This trend is likely to be amplified as the Occupy Wall Street movement continues to expand and local municipalities begin to take more aggressive action against protestors. Despite such distractions, credit-worthy borrowers have been able to take advantage of low interest rates. Even though there is growing uncertainty surrounding the economy, the good news is that there is relatively little risk of an increase in interest rates over the near term.

Consumer Confidence

Consumer confidence levels continue to languish at cyclical lows, with more downside risk than upside potential. While some consumers have experienced a slight uptick in the current situation, partly due to a modest decline in energy prices, their expectations have slipped since mid-year when it looked like things might be improving. Some of the improvement in confidence levels may have been a false signal, with consumers taking some solace from the decline in budget-related headlines that dominated the news earlier this year. However, since Washington will be forced to address a number of difficult issues before the end of 2011, consumers will be subjected to a rollercoaster ride that is likely to be unsettling at best. At the same time, stock market declines have hit the full spectrum of consumers. This is causing the upper end to fear additional erosion in wealth and causing mainstream consumers to worry about another round of employment losses. This downward pressure has been felt by consumers lucky enough to have individual retirement accounts, which experienced significant declines in the third quarter. The timing of this bad news, coupled with growing angst over the anti-Wall Street movement, is heightening discontent among many households. The fact that political pressure has put Medicare and other entitlement programs that had been considered off-limits into the mix will cause consumers to pause even more as they face the prospects of lower benefits and pressure to defer retirement.

Looking forward, there are likely more downside risks for consumer confidence than upside potential. According to a recent Gallup poll, some 80% of respondents believe that the economy is already in recession. Furthermore, their outlook for the economy is tepid at best, with over 60% expecting to experience similar economic conditions a year out. This sense of pessimism may explain the growing appeal of the anti-Wall Street demonstrations and increasing array of agendas that reflect the underlying discontent of Americans.

Concerns over erosion in net disposable income associated with rising costs of healthcare, other benefits, and lack of wage gains continues to bother consumers. Recent reports of the decline in inflation-adjusted median household income over the past two years document the experience of many households during the economic recovery. For the two years ending June 2011, median income fell some 6.7%, which was more than twice the rate of erosion during the official recession. This lagged decline explains some of the separation between consumers and official statisticians, with consumers leading on the downturn and lagging on the upturn. The current situation does not bode well for the economy, with a growing number of consumers feeling like the double-dip has already occurred. This pessimism is likely to carry well into 2012 unless some unexpected events occur that resolve the growing discontent that is spreading across the country. The situation could erode further if politicians are unable to work out a budget compromise—an outcome that is becoming more clouded as lobbyists and special interest groups dig in their heels.

Retail Sales

The retail arena has been one of the bright spots on the economy, although the good news has been moderate and concentrated in two segments: the upper-end or luxury segment, and the lower/value-oriented segment. However, these two segments have not been immune to the economic situation, with the upper end facing downward pressure from stock market declines. At the lower value end of the market, retail sales have focused on needs rather than wants. Consumers are deferring purchases of nonessentials. This situation is likely to continue, with the sagging single-family market and the weak jobs market hanging over the heads of consumers. Interestingly, the relationship between consumer confidence and retail sales has widened, which has resulted in actual spending levels that belie traditional forecasts. This disconnect helps explain some of the optimism among the retailers that outperformed expectations. However, within the absence of income growth and the deterioration in investments, recent gains are not sustainable and may be quickly reversed.

Automobile sales have surprised on the upside, with consumers taking advantage of the easy credit and low interest rates the industry has offered. Despite the upward trend, many households have opted to hang on to existing autos and try to squeeze another year or so out of them. The important back-to-school numbers were moderately positive. But, rather than relying on revolving credit, consumers have continued to deleverage, signaling their continued sense of concern. Sales for online businesses continue to grow, with total market share moving into the 5% zone—a major milestone.

The better-than-expected jobs report for September and a moderate uptick in some other indicators were well-received by retail sales forecasters. Despite some improvement in sales, it is likely that the recent upturn is a mere blip rather than the start of a trend that would suggest consumers are back en masse to help lead the recovery. Thus, the outlook for holiday sales is moderate-to-guarded, with consumers looking for some signs of improvement in the economy that offsets the losses they have experienced in personal balance sheets and net income. In this environment, before registers start ringing, consumers will have to see tangible improvement in their current situations or, at a minimum, start believing that politicians have their best interests at heart and are serious about stimulating the economy. With the stakes as high as they are on the political front, and all parties and candidates sharing in the heat, it is not clear that such a scenario is likely.

As in the past several years, the retail scene is expected to be dominated by value, which will continue to be a key mantra for consumers. This outlook will force retailers to make tough decisions at a time when they were hoping to wean consumers off of the discount trail. Indeed, the fate of several companies embarking on everyday low pricing and eschewing discounts will be closely watched by others who are tired of the seemingly relentless pressure on sales to entice consumers. Similarly, the recent push to resurrect layaway programs will be interesting, especially if retailers are forced to turn to discounting and consumers who go long on purchases wind up with overpriced items. One of the wild cards on the retail front will be apparel. Consumers have come to expect prices to remain stable, and retailers to absorb increases in order to maintain market share. Apparel import prices are likely to rise, however, which will force retailers to make hard choices as to whether they can afford to accept lower margins or risk alienating consumers by reducing discounts.

Going forward, mainstream consumers can be expected to scale back their discretionary purchases and focus on smaller ticket luxuries that are in line with economic conditions. The fate of the upper end of the market will depend, in part, on the stock market and deliberations regarding changes in income tax rates to deal with the record budget deficit.

Housing Market

The housing market continues to languish; but there was a positive side. Existing home sales were a pleasant surprise in August, beating expectations and reversing the downward trend that had held during the year up to that point. While it was nowhere near the levels needed to portend a recovery, the news was well received. In terms of housing values, price declines have slowed somewhat. Despite this improvement, only a third of housing markets have posted median prices that are higher than year-ago averages. Regarding new homes, sales have been lukewarm; although, the pace has picked up over the 2010. Not unexpectedly, homebuilding rates have continued to slip, falling below already guarded expectations. Despite a continued strong interest in multifamily investments, the biggest decline in housing starts in August was in that sector, while single-family homes already hovered at the bottom of the cycle. Homebuilder sentiment has continued to suffer with no signs of an impending reversal in light of disappointing sales volumes.

Indeed, mortgage foreclosure activity increased during the 2011 second quarter, and reversed a downward trend that had been experienced over the past five quarters. At the same time, delinquencies have increased with the biggest uptick occurring in loans backed by federal agencies. At this point, there is little hope that the government will be able to do anything meaningful to help distressed homeowners. For example, of the $1 billion earmarked for foreclosure prevention, only $500 million of the funds were dispersed by the end of the program that had targeted the unemployed. Thus, rather than reaching 30,000 households that were targeted, only half were really helped. At the same time, California pulled out of the settlement negotiations with banks over alleged foreclosure abuses, putting a proposed $25 billion settlement that had the backing of 50 state attorney generals and the White House at risk. The deal breaker was the mandatory release of cooperating banks against other legal claims, a concern that was shared by a number of other states; but, it was not acted on to this point. While these negotiations have been going on for almost a year, a new threat to banks has surfaced as the Federal Housing Finance Agency (FHFA) prepares to sue some of the largest banks in an attempt to recover losses incurred by Freddie Mac and Fannie Mae on securitized mortgages for which issuers misled investors regarding the underlying risk.

As if the situation isn't bad enough, the reduction in maximum loan limits that government-sponsored entities (GSEs) can purchase will put a damper on significant segments of the market—especially the higher end. This will involve two types of limits: a set of limits for FHA-backed loans, and a set of limits on conforming loans that Fannie Mae and Freddie Mac can purchase. The magnitude of declines will vary by market, depending on the cost structure. This will create a complicated patchwork of mortgage credit access and pricing that will add to existing confusion in the market and put downward pressure on the prices of affected properties. This change will help the government achieve its goal of getting out of the residential mortgage business, where its market share has reached some 90% of the residential market. But, it also raises significant questions and adds even more uncertainty to the already beleaguered industry.

The outcome of the decrease in conforming loan limits will be closely watched. It may be a precursor to changes that will ultimately occur when the government steps even further back from the residential market as the fate of Fannie Mae and Freddie Mac is determined. While banks are expected to fill some of the void, questions remain regarding the impact on the housing market. Given the plight of the housing market, its consumers, and the broader economy, this is no time to be experimenting. While Congress could step in and reinstate loan limits, the political wrangling that has occurred and the importance of other issues make this an unlikely proposition. Thus, the situation is not expected to receive the attention it warrants, at least over the short term.

Despite record-low interest rates, refinancing activity has continued to underperform expectations. This situation can be explained by a number of factors, including homeowner uncertainty. At the same time, underwriting standards have been tight due to lenders eschewing risk in favor of more stable, predictable returns. Additionally, a significant number of home loans are underwater. The bottom line is the housing market is a troubled industry that will continue to languish until the economy picks up. Even then, the housing market will face an uncertain fate over the next several years.

Real Estate Overview

Overview

The commercial real estate market has shown some stabilization in real estate fundamentals; although, there are few signs of any improvement on the demand side of the equation. The recent erosion in economic prospects has forced many companies back on the sidelines, especially with regard to expansion plans. On the public side of the market where stock prices are quicker to react to changes in market conditions, the pause in market fundamentals took some of the bloom off of real estate investment trust (REIT) prices. This is driving them back in line with stock markets and disrupting their recent string of outperformance. While the private market has not experienced such a correction, there is likely to be added downward pressure on prices. This correction could reverse the unrealized value gains that had bolstered NCREIF returns and allowed them to bounce back from the declines experienced in 2010.

In this environment, underlying property fundamentals that vary by property type, subtype, market, and submarket will take on added importance to the overall industry health. Capital and spatial markets are expected to get reconnected, which will be an interesting change during a time of general discontent and rising uncertainty.

Office Market

On the surface, it might appear that the slowing economy would be undercutting office market fundamentals. While there is likely to be some downward pressure if the economy stumbles, through the first half of 2011 the office sector experienced modest improvement in occupancy levels. This is a trend that carried into the summer. Despite this improvement, however, rental rates continued to be sluggish due to a lack of demand and overall soft market conditions. With respect to central business districts (CBDs) versus suburban office conditions, CBDs have had the edge; although, this advantage disappears for some markets that are languishing due to a combination of oversupply and lack of job growth.

Some markets continue to show signs of improvement by creating an uneven playing field with some winners that have moved away from the pack. However, to the extent companies postpone expansion plans and step back and reassess the disappointing economic environment, office market fundamentals are likely to plateau. This situation will not occur across the board, with upper-end properties doing better than lower-grade properties and some markets exhibiting even greater improvement than the national averages. This divergence in market performance is expected to become greater, with tenants being selective as they try to keep options open and, where possible, upgrade facilities without incurring a commensurate increase in rents.

On the transaction front, during the first half of the year, sales of top-tier properties were surprisingly strong, with investors seeking safety and willing to pay top dollar to tie up properties. This situation slowed down during the summer as investors began to reassess their pricing models and shift attention back to fundamentals. This pullback was especially pronounced for Class B and Class C properties, as well as suburban locations that had benefited somewhat from the frenetic activity at the top end of the market. Capitalization rates have stabilized to some extent; but, they remain below the peak that occurred toward the end of 2009. In terms of players, private-equity and institutional investors have been the most aggressive—especially for larger assets.

With respect to performance, NCREIF office returns were strong and outpaced changes in underlying market fundamentals with annualized rates coming in the mid-teens through the first half of the year. While the third quarter figures are not available, it is likely that total returns moderated in line with growing economic uncertainty and a decline in transaction volume. On the public side, office REITs lost ground during the turmoil in September that resulted in some 10% loss in total returns. Delinquency rates edged up recently, although still slightly below the overall averages. On a positive note, office construction levels remain well below averages as the market pulls back. This should help stabilize market conditions. Going forward, performance in both the private and public sector are likely to become more aligned with the underlying property fundamentals.

Retail Market

After some improvement tied to the increase in retail sales in the second quarter, the retail sector has slowed, with no major changes in either the demand or supply sides of the market. With respect to transactions, the retail sector has performed better than other property types. August data showed the retail sector outpacing other property types; but, despite this competitive advantage, the sector later lost some momentum as investors have pulled back. This was understandable after the retail sales spurt at mid-year, and was followed by declining consumer confidence and deterioration in the economic recovery. The exception to this pattern was in grocery-anchored strip centers, which enjoyed a surge in transaction activity as investors continued to hone in on this segment.

Recent retail construction levels have been fairly well contained as the economy has struggled to break out of the recession, and there are some signs that the outlet center segment may be in for a significant growth spurt. New entries have jumped into the market, chasing strong performance racked up by the current market leaders. Value is expected to remain high on the list of consumer demands. Whether that orientation will support new development activity will be interesting to watch. This is especially true since retailers across the board have a renewed awareness of the importance of value and are adopting a number of initiatives to address that end of the market.

With respect to retail subtypes, grocery-anchored neighborhood strip centers have had the highest performance and benefited from strong investor demand that drove values. Super-regional malls are also ahead of the pack, followed by regional, and community centers that are caught in the middle of the retail spectrum with no particular competitive advantage. This pattern is likely to hold, with the market becoming more bimodal with strength at the upper and lower ends, and weakness in the middle. On the public market front, recent retail performance has been disappointing; although, the sector declines in September were lower than the overall averages and other property types with the exception of apartments. On a year-to-date basis, regional malls have eked out a slightly positive return. Meanwhile, the broader class of retail properties including grocery-anchored segment lost more than the overall average at 10%. Retail delinquency rates in commercial mortgage-backed securities (CMBS) pools edged up in September; but, they are still below current industry averages and remain the best-performing property sector, although they are still significantly above long-term averages.

Going forward, retail fundamentals and retail investment performance levels will depend on the fate of the economy and the ability of consumers to regain confidence and regain ground on declining portfolios and lost earnings.

Industrial/Warehouse Market

Industrial market fundamentals have gradually improved during 2011, with some moderate softening over the past quarter as the economic recovery stumbled a bit. However, absorption continues to be positive. When combined with tempered construction levels outside of build-to-suits, this helped push vacancy rates down. Despite the improvement, asking rents for overall industrial properties have not risen—with exception of the warehouse/distribution segment which enjoyed modest gains. Due to the relatively high level of integration between the industrial market and the economy, there is some downside risk to the sector in terms of fundamentals. However, the recent improvement in exports and global developments provide some upside potential, albeit at tempered rates over the near-term.

Industrial transactions have tapered off somewhat; although, available product levels have remained relatively stable. Capitalization rates have continued to trend down, which was welcomed news, after the recent efforts to clear the backlog of distressed assets put some upward pressure on yields as investors focused on the risk side of the equation. Private investors and unlisted REITs have been the most active on the buy side; but, other investors continue to be drawn to the sector in search of more stable returns.

During the first half of the year, the private industrial market enjoyed relatively strong performance that was in line with the improving economy. Reflecting the nature of the economic recovery to that point, the warehouse and R&D segments of the market experienced the strongest returns on a trailing twelve-month basis, with R&D pulling ahead in the most recent period.

On the public side of the market, with the exception of the volatile hotel sector, the industrial sector had the greatest losses through September, bringing total returns down some 20% on a year-to-date basis. While the latest figures showed some improvement as manufacturing and distribution activity picked up, the sector is still struggling along with the other property sectors affected by the overall economic conditions.

> "Industrial market fundamentals have gradually improved during 2011."

On the delinquency front, the industrial sector has experienced the greatest increases, with rates rising above 11% in September.

Apartment Market

The multifamily housing market experienced improvement during the first half of the year. This helped lead to improvements in the Multifamily Production Index (MPI) compiled by the National Association of Home Builders (NAHB), and an increase for the fourth consecutive quarter. This trend held during the 2011 third quarter, with multifamily rental housing construction levels trending upward and leading other property types. The change in tenure preferences from own-to-rent associated with the collapse of the single-family market explains some of the excitement surrounding the sector. To this point, the industry has avoided overreacting to the anticipated increase in apartment demand; although, there are some signs that the industry might get overbuilt if capital continues to flow into the sector. Over the near-term, apartment vacancy rates are expected to continue to fall, and this will provide support for some of the rental spikes and increases built into recent pro formas as investors flocked to the property type. Despite the recent surge in development, new construction activity remains below long-term averages. This is also true on the single-family side of the industry—but, for very different reasons.

With respect to private investment performance, apartments led the pack during the first half of the year and racked up total returns over 20%. Although the third quarter data was not available at press time, it is likely that apartment returns have lost some of the momentum. But, the continued plight of the single-family market and strong investor demand may have bolstered values beyond those supported by underlying market fundamentals. This is especially true on the supply side, with apartments being the favored property type and investors and lenders willing to provide capital. On the public front, apartments have been the best-performing property type; although, that comparison benefits some from the malaise surrounding other property types. With that caveat aside, the apartment sector has turned in moderately positive total returns through September. However, the latest monthly figures were more negative for apartments than they were for other property types including hotels, which had not experienced the same highs earlier in the cycle.

Despite improving market fundamentals at an overall level and strong investor demand for apartments, the sector is the worst performing of all property types in terms of delinquency rates. This situation deteriorated even more in September, with apartment delinquency rates pushing 17%. This was more than twice the industry average and ahead of hotels, which are generally perceived as riskier investments.

Real Estate and Capital Markets

Capital Market Overview

From a macro-perspective, the real estate capital markets continue to be relatively healthy—with the exception of the CMBS market that lost its footing and unexpectedly stumbled after getting off to a good start. During the first three quarters of 2011, transaction volume was relatively healthy; although, activity did taper off in early fall.

The distressed asset picture has cleared up a bit, with monthly additions slowing down; but, it is not clear if that is a trend or whether it was a cyclical pause that may evaporate as players take a hard look at where they stand at year-end and what the outlook is for the near term. The recent economic downturn may cause some borrowers of distressed assets to realize they cannot wait for a widespread recovery to bail them out, which could lead to a string of strategic foreclosures. On the other hand, lenders are likely to remain reluctant to take back additional properties going into a period when it may be more difficult to move troubled assets off the books. Assuming there are no major shocks, the good news is the surge of distressed assets seemed to have peaked for the near term as players on all sides of the market try to get a better handle on what the future is likely to look like both on the spatial side of the market as well as on the capital side of the market.

Although the current acceptance of low yields is not consistent with long-term yield requirements, the phenomenon can be understood by the fact that investors seem to have shifted toward spread investing. Even though yields are low by historical standards, many types of investors who approach real estate from a long-term hold stance believe the yields may make economic sense and may fit into a broader portfolio strategy that offers few alternatives. It will be interesting to see how such a strategy plays out over an intermediate holding period when investors try to exit investments in a sales environment where the market requires exit capitalization rates that are significantly higher than going-in capitalization rates, as well as rates built into current pro formas. That said, in the absence of significant erosion in real estate spatial fundamentals, pent-up demand for assets and the tolerance for low yields may help hold values. At some point in the cycle, investors will begin to pay more attention to the underlying risk/return relationship for real estate compared to other asset classes. Assuming other assets recover along with the economy, and real estate lags as it typically does, this scenario will create some endogenous downside risk exposure. This situation is likely to be exacerbated by the $1.3 trillion or so in balloon loans that will be maturing at a pace of some $300 billion a year in 2012.

Real Estate Capital Markets

The real estate capital markets have become somewhat muddled, with lenders and investors pulling back on plans to take on moderately higher risk in search of higher returns. This has left the market bifurcated, with upper-end product continuing to attract investors willing to accept low returns, and moderate-to-lower end product scrambling for capital. Cross-border investors are expected to continue to be active, benefiting from the weak dollar and a tolerance for lower returns when relatively stable US assets are compared to those in other countries. While the volume of acquisitions and dispositions by this category of investor over the past ten years has been relatively modest, they have continued to be net buyers of real estate. This situation is likely to continue with an increase in net acquisition activity as the global economic turmoil—particularly true in Western Europe—hangs over global market and is likely to persist for some time. In terms of players who have been active over the past decade, institutional funds have been active in the market and have been net accumulators of real estate as acquisitions have outpaced dispositions. On the other hand, public investors and private equity investors have been active; but, they have been net sellers. While equity investors are likely to remain active, transaction volume will be somewhat suppressed over the near term.

Mortgage Market

In general, credit market conditions have tightened and, in the wake of the recent turmoil in the CMBS market, are likely to continue to be tight—especially for commodity real estate and riskier properties. While traditional lenders will step partially into the void, the stumbling economy and potential erosion in underlying market fundamentals will keep them in a defensive posture that will create some capital voids.

The CMBS market has experienced a number of setbacks, led by rating agency actions that caught the market by surprise and effectively shut the door on new issuances. While some transactions are still getting done, credit enhancement levels have been increased to attract buyers. Even so, the market is stymied by the lack of action among the critical B-piece buyers whose participation is necessary to support higher-rated tranches that require lower yields and help bring down average costs of capital.

In addition to the problems with credit support and finicky investors, the CMBS industry continues to struggle with stubbornly high delinquency rates. The good news is that the $1.5 billion in new delinquencies in September was the lowest rate in three years. Even with this improvement, overall rates continue to hover above 9% and have proven to be as stubborn as unemployment rates. Despite the challenges the industry faces, there has been some recent improvement in the pace of resolutions of delinquent loans, which have outpaced the growth in new troubled assets. However, the total amount of delinquent CMBS loans is still above $55 billion, with some more upside risk due to the recent economic downturn that will cause further erosion in market fundamentals. Going forward, the debt markets will continue to support the commercial real estate industry; although, it is not at the rate necessary to support the full spectrum of deals that the market will try to affect.

Conclusion

The fourth quarter of 2011 may well be the "fall of our discontent" that will carry across the economic, real estate, and capital markets. This situation is a disappointment relative to what many thought would unfold as the 2011 second quarter wound down. Some contend that the negative world view is based on false perceptions and has been skewed by the combination of muckraking, tweeting, and twisting in the face of the significant headwinds ahead on all fronts. Indeed, there is so much uncertainty that it is difficult to determine how things will actually unfold. To the extent that much of the hesitancy in the market is based on a combination of discontent and lack of confidence, a defensive posture will be an important survival tool. A number of scenarios could change the prognostication and provide some real upside surprise. For example, Washington might actually shift from being combative to being collaborative; the Occupy Wall Street might actually have an impact and lead to action; Main Street might really begin to matter and be given a voice in how we move forward; or, the world economy might return to prosperity. It could happen; but, in the meantime, most will tread lightly into the darkness of uncertainty and discontent.

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